Commonwealth Private

July 2025

Market Outlook.

Assessing the longer-term implications of AI for investors.

Foreword

As at the end of June 2025, policy uncertainty, moderating economic growth, geopolitical conflicts in the Middle East and questions surrounding the durability of US exceptionalism are all dominating investors' minds. Despite the significant events of the first six months, most equity markets remain above where they started the year, having recovered strongly from the April sell-off.

In addition to the policy and geopolitical uncertainty, Commonwealth Private believes that technological advancement is at the forefront of the themes likely to shape future returns. Monetisation of artificial intelligence (AI) across the broad economy lies at the heart of how this theme will play out. While enthusiasm for technological progress is robust, the practical benefits of this rapid advancement are yet to be fully demonstrated. The stakes are considerable, with the 11 largest cloud companies including Microsoft, Alphabet, and Amazon collectively expected to invest US$392 billion in tech and AI-related capital expenditures (Capex) this year alone[1].

The AI enablers, such as cloud, software and semiconductor manufacturers, will only see sustained success if their customers are able to derive meaningful benefits from the application of AI into their business. This has already occurred in certain industries; however, it is still early in the piece broadly. Market concentration and high equity valuations among US mega-cap companies has further created an environment with minimal margin for error.

The next five years could look quite different to the past five for listed equities, where a handful of large, strongly performing US stocks have driven market-wide outcomes. Going forward, we anticipate a convergence of equity returns between the US mega-caps and the broader constituency. This broadening-out process could take several paths. The first potential scenario is that AI fails to monetise at scale globally, where AI integration doesn't meet expectations to improve cost or revenue outcomes.

This outcome would result in the large AI enablers "catching down" to the broader global equity market. Higher research and development and Capex spending in recent years has seen many US technology companies transform from being capital light businesses to being significantly more capital intensive. Failure to deliver customer value, would result in significant write-downs from those firms providing the AI building blocks. Overall, in our view, it's more likely however, that AI ultimately scales to deliver significant productivity improvements across a multitude of industries worldwide.

The implications of widespread AI monetisation are also complex for investors. This scenario could catalyse further fundamental shifts in equity market performance between different sectors and companies. Even with broad adoption, the productivity benefits of technology probably won't be distributed evenly, with distinct winners and losers among the adopters. Companies with a strong competitive advantage will thrive by translating AI-related cost savings into higher margins and profits. Conversely, those lacking a competitive edge may struggle, with cost savings likely to be passed back to consumers – even though they'll still be compelled to invest and adopt AI, just to keep up.

Going forward, we expect equity market convergence to unfold, due to the improved operating performance of many companies from the application of technology. However, discerning whether these operating improvements translate into sound investment performance will require careful evaluation. It'll require a detailed, individual assessment of each firm's scope to drive efficiency together with their competitive positioning. This underscores why the upcoming period will demand a more active and engaged approach to equity ownership.

James Foot, Chief Investment Officer
Commonwealth Private

[1] Source: Morgan Stanley

Global Economics:

Slowing growth

- Trade tensions, monetary policy, and geopolitical shocks converged to test the resilience of markets and investors in June.
- Global economic growth has begun to lose momentum.

Geopolitical risk surged as conflict erupted in the Middle East, briefly driving oil prices up 10% and threatening to erase earlier disinflationary gains. However, a ceasefire between Israel and Iran brought oil prices back down. Economists warn that a sustained oil shock could cut 0.7% from global gross domestic product (GDP) in the second half of the year if hostilities resume.

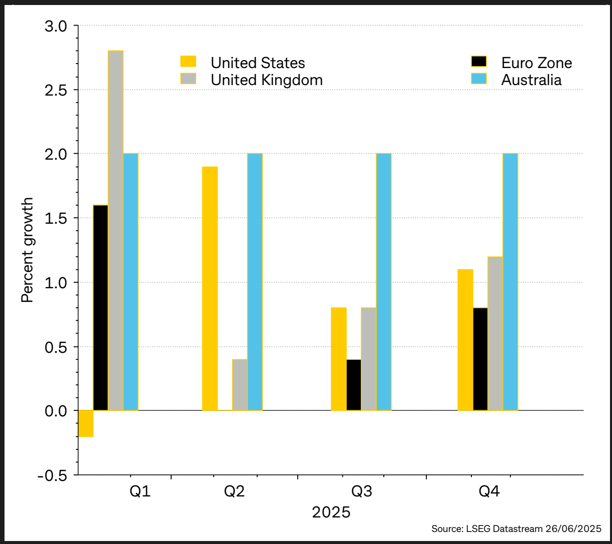
Global economic growth, which had shown surprising resilience in Q1, began to lose momentum in June with the US, Eurozone, and China all reporting signs of slower activity. Despite a strong start to the year, driven by front-loading of imports ahead of new US tariffs, the effect has reversed, and US imports fell sharply, and global trade volumes softened. Purchasing Managers Indexes (PMIs) for new export orders dropped below 50 in nearly 70% of major economies, signalling contraction in global trade activity.

The drag from tariffs on US economic growth is expected to only become clear in the second half of 2025. Immigration restrictions are also expected to weigh on labour markets, reducing potential GDP growth and putting upward pressure on wages and prices. The sustainability of the US fiscal position also remains a focal point.

China's growth is expected to moderate from 5.4% year-on-year in Q1 to 4.5% for the full year, as export headwinds and weak consumer confidence weigh on activity. Meanwhile, the Eurozone faces sub-1% growth.

Global growth expectations

% GDP Growth



Inflation trends diverged sharply across regions in June. In the US, the impact of tariffs is beginning to filter through, input costs for manufacturers surged to their highest since 2022, and about two-thirds of firms attributed rising costs to tariffs. While CPI rose just 0.1% for the month and 2.4% year-over-year, economists expect a spike in the second half of the year as businesses pass on higher costs to consumers. Elsewhere, inflation is moderating. The Eurozone's headline inflation fell to 1.9% in May.

The US Federal Reserve (Fed) left rates unchanged in June and signalled a cautious approach, whilst the European Central Bank (ECB) cut interest rates by 25 basis points at its June meeting and signalled further easing if disinflation persisted.

Australia Economics:

Lower growth and inflation allow for further easing

- Recent economic data confirms a subpar growth and benign inflation picture.
- Combined with a challenging global growth and policy environment, these elements provide scope for multiple Reserve Bank of Australia (RBA) rates cuts this quarter.
- Conditions are supportive for key asset classes, including residential property and fixed income credit.

The latest string of economic data has highlighted that Australia's economy is growing at a positive but sluggish rate, but with inflation pressures contained. This was best displayed in the latest GDP outcome noting annual growth remains tepid at 1.3% and real GDP growth surprising to the downside.

While weaker domestic consumer sentiment is nothing new, the closely watched NAB Business Survey took a turn down in May with business conditions sitting below the long term average. Encouragingly, at 2.1% annualised, the May CPI Indicator printed below consensus driven by an easing of market services inflation.

The unemployment rate remained steady at a low 4.1% in May, however employment unexpectedly declined by 2,500. While this monthly data series is volatile, combined with the weaker-than-expected Q1 2025 Labour Account, there are early signs of a slowdown in non market employment which has been a key buffer for the broader labour market in recent years. The continued easing in Australia's population growth (annual rate down to 1.7% in Q4 2024), adds to this thesis.

Of course, subpar domestic economic growth partly reflects a continuing uncertain policy and growth environment offshore, with the outcomes of tariffs between key countries and the US not fully resolved, US policy uncertainty remaining high on key fronts (including taxation and immigration), and lingering conflict in the Middle East, as mentioned in the Foreword.

RBA cash rate

Current and consensus forecast

Source: LSEG Datastream 26/06/2025

Weaker growth and higher confidence on their inflation outlook will allow the RBA to cut rates this quarter.

From July, CBA forecasts two additional rate cuts in this cycle taking the cash rate to 3.35%. There is the risk of an additional rate cut this cycle with the timing and likelihood of this depending on incoming economic data and offshore developments. We note this contrasts to the Fed's data dependent position as noted in the Fixed Income section to follow.

Overall, this environment of lower, but positive growth and rate cuts is favourable for key asset classes, including property (notably residential), and fixed income credit, with key risks including stagflationary conditions and higher interest rates globally.

Equities:

Macro still dominates

- Markets have rallied back strongly from their April sell-off, as news flow continues to improve.
- Relative value exists outside the US.

Equity market strength has been a talking point in June, as the flow of news continued to be “less bad”. Resilience in labour markets, the dialling down of trade fears and the containing of Middle East tensions were all recevied positively. Now with rate cut expectations ramping up, the positive tone has improved again.

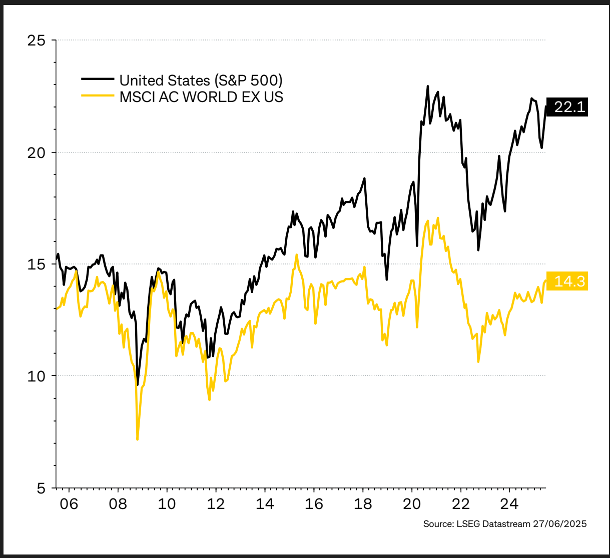
In view of this more buoyant sentiment in equity markets, it’s important to take stock of where valuations sit on a relative geographic basis and consider where the best risk adjusted returns are likely to be derived going forward. After all, the best investments are made when fundamentals are under-appreciated, not when everyone agrees on the same idea.

The S&P 500 trades at around 22x earnings, with the US comprising close to 65% of the MSCI ACWI Index. In 2010 this was just 43% with a multiple of 15x. It’s hard to recall the last time the US underperformed the rest of the world, but there were 10-year periods in the late-1980s, early-1990s and again in the 2000s where this happened. Will the US equity dominance repeat? As discussed earlier, our view is that much will depend on how successfully AI is monitised through the economy going forward.

On the flipside we believe European and Japanese markets provide a mix of valuation, policy support, and improving fundamentals. Europe has benefited from renewed fiscal investment in defence and infrastructure, particularly out of Germany. Further rate cuts from the ECB will also assist.

Equities recover from April sell-off

Market Indices



In China, policymakers have also signalled that they want local stocks higher and are also pushing stimulus to support growth in light of the trade war. Finally, emerging market’s equities could thrive if the US dollar continues to weaken. These dynamics underscore why we remain regionally well diversified in our international equities set up, notably with a slight underweight to US equities.

The Australian equity market has also staged a strong comeback from the tariff-induced lows, with over 90% of sectors up by more than 10% and the ASX 200 hitting record highs. The Information Technology sector alone is up over 40% from the trough, aided by expanding P/E multiples. Yet, beneath the surface, earnings revisions have been negative in most sectors outside Tech, Communications, and Healthcare, against an economic backdrop that remains subdued.

While markets have recently been dominated by global macro forces, both locally and globally, it’s our opinion that opportunities will be increasingly found through a more company-specific approach.

Fixed Income:

Long yields decline on growth concerns

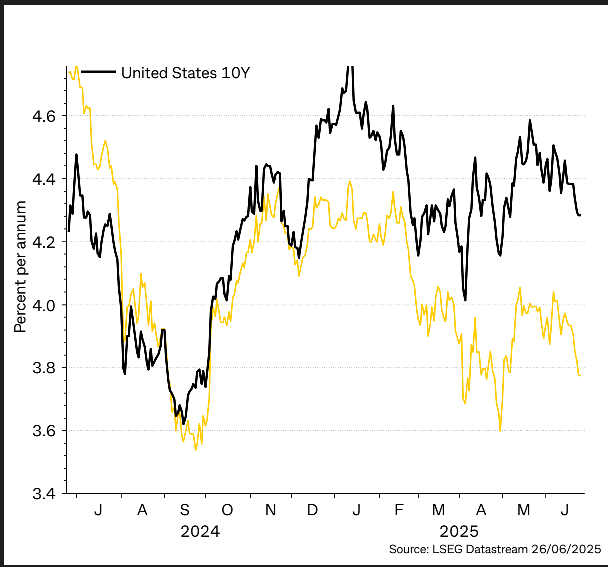
- Recent declines in US and global 10-year bond yields reflect growth concerns more so than forecast Fed easing.
- While the Fed is now in "wait and see" mode, the RBA looks set to deliver multiple rate cuts in this current quarter as indicated by falling short-term AUD interest rates.
- This environment in H2 of slower growth, easier fiscal and monetary policy and lower real bond yields is supportive for this asset class, with Tier 2 considered a sound source of risk-adjusted returns within fixed income.

Bucking the recent trend, 10-year bond yields in the US pulled back last month led more so by growth concerns as opposed to expected US monetary easing. Indeed, the FOMC left the Fed Funds rate steady last month but flagged a stagflationary impulse to the US economy from tariffs. While market pricing in late-June pointed to two further rate cuts, Fed Chair Powell was at pains to highlight the current uncertainty (while also announcing plans to reduce US banks' capital requirements). This uncertainty stems from the ongoing US tariff negotiations and the implications for inflation. Put another way, if US inflation jumps higher in coming months, it will be hard for the Fed to cut rates multiple times. Locally, as noted in Australian Economics, the RBA is now expected to cut at least two times this year.

Overall, this prospective environment of higher starting interest rates, slower growth and easier fiscal and monetary policy is supportive for credit fundamentals and credit spreads, and fixed income generally. The key risks to this sanguine outlook include credit spread widening (noting that US investment-grade credit spreads are now back to pre-Liberation Day levels) and the emergence of stagflationary conditions, especially in the US.

Long-dated UST yields have declined

2-year and 10-year UST yields



Hence, the need for our managers in our core fixed income model to remain flexible and dynamic in their portfolio management.

In terms of year-to-date domestic credit supply, while overall issuance to 31 May was down 8% on the comparable period in 2024, it'll be another record half of Tier 2 supply in the first half. This is consistent with the expansion of the domestic Tier 2 sector in recent years, reflecting a range of drivers including APRA phasing out domestic bank hybrids in favour of Tier 2 capital. This expansion of local supply volumes, has seen new investors enter the fray, prompted by S&P's rating upgrade of major bank Tier 2s to A- last year.

Factoring in the key risks for Tier 2 bonds (including call risks and the higher market sensitivity of Tier 2 debt), with investors still able to achieve a mid-to-high 5% yield from well-capitalised major bank Tier 2 issues, Commonwealth Private considers this a sound source of risk-adjusted returns within fixed income. Key access mechanisms include the Australian funds which all hold material exposure to AUD subordinated debt.

Real Assets:

Real Assets build on solid foundations

- Real Assets such as Property and Infrastructure can provide long-term investment stability.
- It can also provide a hedge against the inflationary-based erosion of asset value.

Returns from global listed property securities were approximately flat in June, while global listed infrastructure securities declined slightly. Over the year-to-date, returns from these asset classes are positive and have shown lower volatility compared to equities. This performance reflects the solid grounding of real asset investments, particularly in periods when inflationary concerns are heightened.

From a valuation perspective, property and infrastructure securities continue to trade at levels which are not significantly elevated compared to historical levels.

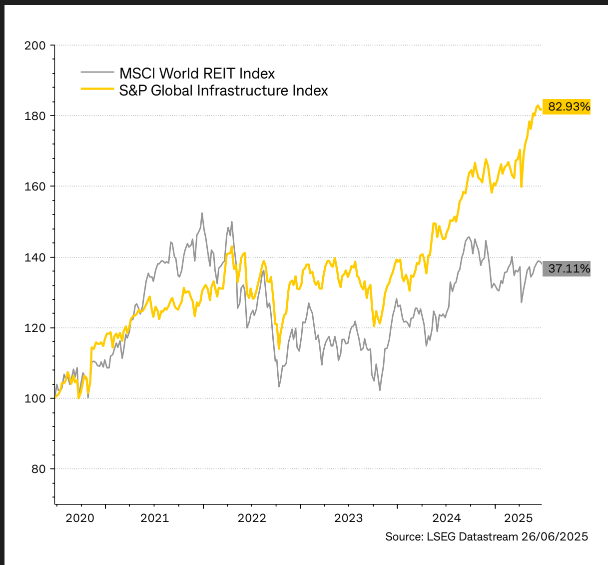
As we consider the outlook for property and infrastructure investments, consensus expectations are that the likelihood of a significant US inflationary cycle (triggered by US tariffs or geo-politics) has receded over the past few months, while expectations that short-term funding rates will decline globally over the second half of 2025 are maintained. Such a reduction in base interest rates will be positive for real asset valuations.

Further, both property and infrastructure assets have large portions of contracted revenue growth that is inflation-linked. The combined effects of reduced funding costs, increased revenues, and current valuation levels give these asset classes the opportunity to benefit from both operational leverage and asset revaluation over the remainder of 2025.

As such, we maintain our positive outlook for property and infrastructure assets as part of a long-term investment portfolio.

Real Asset investment returns

USD Total Return



While direct property transaction activity in Australia had continued to be subdued in late Q2 (contrary to our expectations for an uptick before the end of this financial year), there's been a noticeable uptick in private infrastructure transactions. In Q1 2025, global large transaction deal flow reached USD$150 billion, the highest quarterly level over the past three-years (Source: Goldman Sachs Asset Management). This has been seen in Australia too, with significant transactions involving airports, data centres, ports, and renewable energy.

This asset class continues to evolve, bringing new opportunities to market in sectors such as energy transition, digital infrastructure, and waste recycling. It also encompasses the necessary refreshment and upgrade to electricity infrastructure (such as electricity grids and energy storage), which will provide a base for infrastructure investment and returns in the decade to come.

Alternatives:

Long-term return drivers remain intact

- Hedge Funds aim to provide absolute returns with low correlation to traditional asset classes.
- Alternative Credit offers enhanced yields.
- Private Equity offers access to value-added opportunities and participation in developing businesses and technologies.

In May-June 2025, global listed equity markets have quickly recovered from the steep selloff in April and are again around all-time highs. Meanwhile, Private Equity (PE) funds have continued to deliver less-volatile returns, supported by the underlying growth of their constituent companies.

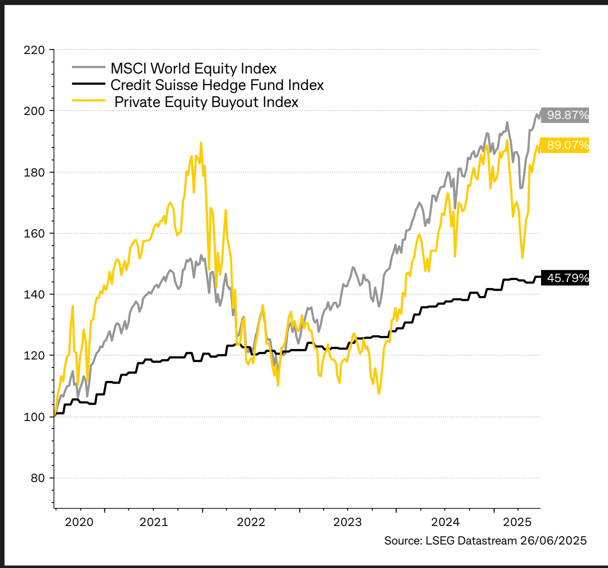
One criticism that has been levelled at PE firms (General Partners, or GPs) over the past few years has been the slow realisation of investor capital, while significant new investor commitments remain unutilised. GPs are now responding more decisively to demands for faster realisation of long-standing investments, whose exits have been variously delayed by the COVID-19 pandemic, valuations that have been challenged by rising financing costs, and investor reluctance to participate in initial public offers (IPOs).

In addition to the usual exit pathways of trade sales and IPOs, GPs have increasingly been exploring GP-led secondary market sales and continuation funds. We also expect IPO activity to increase over 2025, following the example set by the successful re-float of Virgin Australia in June.

When considering PE investments, it is important to take account of the underlying constituent companies. Many PE portfolios have direct exposure of between 15% and 30% to the technology sector, as well as investment exposure to companies in other sectors which benefit from the use of new technologies. Together, the embedded use of AI and other efficiency drivers are aimed at producing better, more efficient, outcomes for these companies and their clients, as well as producing superior returns for investors.

Alternative investment returns

USD Total Return



Overall, returns from Alternate Credit over the year to date have proved resilient to the recent market turmoil, albeit not completely immune to credit spread widening in March and April. We believe that overall conditions continue to be productive, given the current environment in which interest rates are not too high, economic growth is moderate, the demand for and supply of credit is tempered by both borrowers and lenders exercising fiscal responsibility, and that credit spreads remain above their historically low levels.

Given the fast-moving nature of markets and global geopolitics, we believe that such investments are best accessed via active managers which can: (a) provide a well-diversified portfolio of investments, (b) select investments which are not directly exposed to policy risks (such as tariffs), and (c) actively reposition the portfolio according to fundamentals and relative value, as well as capitalise on opportunities created by broad market movements.